Board believes that removing "pattern or practice" and providing creditors a presumption of compliance will be more effective to prevent unfair practices, remedy them when they occur, and preserve access to credit.

Imposing the burden to prove "pattern or practice" on an individual borrower would leave many borrowers without a remedy under HOEPA for loans that were made without regard to repayment ability. Borrowers would not have a HOEPA remedy for individual, unrelated loans made without regard to repayment ability, of which there could be many in the aggregate. Even if an unaffordable loan was part of a pattern or practice, the individual borrower and his or her attorney would not necessarily have that information. n63 By the time information about a particular lender's pattern or practice of unaffordable lending became widespread, the lender could have caused great injury to many borrowers, as well as to their neighbors and communities. In addition, imposing a "pattern or practice" requirement on HOEPA loans, but not higher-priced mortgage loans, would create an anomaly.

n63 Federal rules of civil procedure require that a defendant's motion to dismiss be granted unless the plaintiff alleged sufficient facts to make a pattern or practice "plausible." *Bell Atlantic* v. *Twombly,* 127 S. Ct. 1955 (2007). Many states follow the federal rules.

Moreover, a "pattern or practice" claim can be costly to litigate and might not be economically feasible except as part of a class action, which would not assure individual borrowers of adequate remedies. Class actions can take years to reach a settlement or trial, while the individual borrower who is facing foreclosure because of an unaffordable loan requires a speedy resolution if the borrower is to keep the home. Moreover, lower-income homeowners are often represented by legal aid organizations, which are barred from bringing class actions if they accept funds from the Legal Services Corporation. n64

n64 45 CFR 1617.3.

To be sure, many borrowers who would be left without a HOEPA remedy for an unaffordable loan may have remedies under state laws that lack a "pattern or practice" requirement. In some cases, however, state law remedies would be inferior or unavailable. Moreover, state laws do not assure consumers uniform protection because these laws vary considerably and [*44546] generally may not cover federally chartered depository institutions (due to federal preemption) or state chartered depository institutions (due to specific exemptions or general "parity laws").

For these reasons, imposing the burden to prove "pattern or practice" on an individual borrower would leave many borrowers with a lesser remedy, or without any remedy, for loans made without regard to repayment ability. Removing this burden would not only improve remedies for individual borrowers, it would also increase deterrence of irresponsible lending. Individual remedies impose a more immediate and more certain cost on violators than either class actions or actions by state or federal agencies, which can take years and, in the case of the agencies, are subject to resource constraints. Increased deterrence of irresponsible lending practices should benefit not just borrowers who might obtain higher-priced mortgage loans but also their neighbors and communities who would otherwise suffer the spillover effects of such practices.

The Board acknowledges the legitimate concerns that lenders have expressed over litigation costs. As the Board indicated with the proposal, it proposed "pattern or practice" out of a concern that creating civil liability for an originator that fails to assess repayment ability on any individual loan could inadvertently cause an unwarranted reduction in the availability of mortgage credit to consumers. After further study, however, the Board believes that any increase in litigation risk would be justified by the substantial benefits of a rule that provided remedies to individual borrowers. While unwarranted litigation may well increase, the Board believes that several factors will mitigate this cost. In particular, TILA imposes a one-year statute of limitations on affirmative claims, after which only recoupment and set-off are available; HOEPA limits the strict assignee liability of TILA Section 131(d), 15 U.S.C. 1641(d) to HOEPA loans; many defaults may be caused by intervening events such as job loss rather than faulty underwriting; and plaintiffs (or their counsel) may bear a substantial cost to prove a claim of faulty underwriting, which would often require substantial discovery and expert witnesses. Creditors could further contain litigation risk by using the procedures specified in the regulation that earn the creditor a presumption of compliance.

The Board has also considered the possibility that the statute's "pattern or practice" element allows creditors an appropriate degree of flexibility to extend occasional collateral-based HOEPA loans to consumers who truly need them and clearly understand the risks involved. Removing "pattern or practice" would eliminate this potential consumer benefit. Based on industry comments, however, the benefit is more theoretical than real. While industry commenters may prefer retaining "pattern or practice" as a barrier to individual suits, these commenters indicated that "pattern or prac-

tice" is too vague to be useful for compliance planning. Therefore, retaining "pattern or practice" would not likely lead a creditor to extend legitimate collateral-based loans except, perhaps, a trivial number such as one per year.

The Board reached this conclusion only after exploring ways to provide more clarity as to the meaning of "pattern or practice." Existing comment 34(a)(4)-2 provides that a pattern or practice depends on the totality of the circumstances in the particular case; can be established without the use of a statistical process and on the basis of an unwritten lending policy; and cannot be established with isolated, random, or accidental acts. Although this comment has been in effect for several years, its effectiveness is impossible to assess because the market for HOEPA loans shrank to near insignificance soon after the comment was adopted. n65 On its face, however, the guidance removes little of the uncertainty surrounding the meaning of "pattern or practice." (There is only one reported decision to interpret "pattern or practice" under HOEPA, *Newton* v. *United Companies Financial Corp.,* 24 F. Supp. 2d 444 (E.D. Pa. 1998), and it has limited precedential value in light of later-adopted comment 34(a)(4)-2.) The Board re-proposed the comment but commenters provided few concrete suggestions for making the rule clearer and the suggestions that were offered would have left a large degree of uncertainty.

n65 By 2004, HOEPA loans reported under HMDA were less than one percent of the mortgage market. The Board does not believe the market's contraction can be traced to the guidance on pattern or practice.

The Board considered other potential sources of guidance on "pattern or practice" from other statutes and regulations. Case law is of inherently limited value for such a contextual inquiry. Moreover, there are published court decisions, some cited by industry commenters, that suggest that even a few instances could be considered to meet this standard. n66 The Board also consulted informal guidance interpreting "pattern or practice" under ECOA. n67 The Board carefully considered how it could adapt this guidance to § 226.34(a)(4). Based on its efforts, the Board concluded that, while additional guidance could reduce some uncertainty, it would necessarily leave substantial uncertainty. The Board further concluded that significantly more certainty could be provided through the "presumption of compliance" the final rule provides for following enumerated underwriting practices. *See* § 226.34(a)(4)(iii), discussed below.

n66 *See, e.g., United States* v. *Balistrieri*, 981 F.2d 916, 929-30 (7th Cir. 1992); *United States* v. *Pelzer Realty Co., Inc.*, 484 F.2d 438, 445 (5th Cir. 1973).

n67 Board Policy Statement on Enforcement of the Equal Credit Opportunity and Fair Housing Acts, Q9.

Verification of Repayment Ability

Section 226.34(a)(4) currently contains a provision creating a rebuttable presumption of a violation where a lender engages in a pattern or practice of making HOEPA loans without verifying and documenting repayment ability. The Board proposed to retain this presumption and extend it to higher-priced mortgage loans. The final rule is different in two respects. First, as discussed above, the final rule does not contain a "pattern or practice" element. Second, it makes verifying repayment ability an affirmative requirement, rather than making failure to verify a presumption of a violation.

In the final rule, the regulation applies the verification requirement to current obligations explicitly, *see* § 226.34(a)(4)(ii)(C); in the proposal, an explicit reference to obligations was in a staff comment. *See* proposed comment 34(a)(4)(i)(A)-2, 73 FR at 1732. The requirement to verify income and assets in final § 226.34(a)(4)(ii)(A) is essentially identical to the requirement of proposed § 226.35(b)(2). Under § 226.34(a)(4)(ii)(A), creditors must verify assets or income, including expected income, relied on in approving an extension of credit using third-party documents that provide reasonably reliable evidence of the income or assets. The final rule, like that proposed, includes an affirmative defense for a creditor that can show that the amounts of the consumer's income or assets relied on were not materially greater than the amount the creditor could have verified at consummation.

Public comment. Many, but by no means all, financial institutions, mortgage brokers, and mortgage industry trade groups that commented support a verification requirement. They raised concerns, however, that the particular requirement proposed would [*44547] restrict or eliminate access to credit for some borrowers, especially the self-employed, those who earn irregular commission- or cash-based incomes, and low- and moderate-income borrowers. Consumer and community groups and government officials generally supported the proposed verification requirement, with some suggesting somewhat stricter requirements. Many of these same commenters, however, contended the proposed affirmative defense would be a major loophole and urged its elimination. The comments are discussed in further detail below as applicable.

Discussion. For the reasons discussed above, the Board finds that it is unfair not to verify income, assets, and obligations used to determine repayment ability when extending a higher-priced mortgage loan or HOEPA loan. The Board is finalizing the rule as proposed and incorporating it directly into § 226.34(a)(4), where it replaces the proposed presumption of a violation for a creditor that has a pattern or practice of failing to verify repayment ability. "Pattern or practice" has been removed and the presumption has been made a requirement. The legal effect of this change is that the final rule, unlike the proposal, would rarely, if ever, permit a creditor to make even isolated "no income, no asset" loans (loans made without regard to income and assets) in the higher-priced mortgage loan market. For the reasons explained above, however, the Board does not believe this legal change will reduce credit availability; nor will it affect the availability of "no income, no asset" loans in the prime market.

As discussed above, relying on inflated incomes or assets to determine repayment ability often amounts to disregarding repayment ability, which causes consumers injuries they often cannot reasonably avoid. By requiring verification of income and assets, the final rule is intended to limit these injuries by reducing the risk that higher-priced mortgage loans will be made on the basis of inflated incomes or assets. n68 The Board believes the rule is sufficiently flexible to keep costs to consumers, such as any additional time needed to close a loan or costs for obtaining documentation, at reasonable levels relative to the expected benefits of the rule.

n68 By requiring verification the rule also addresses the risk that consumers with higher-priced mortgage loans who could document income would unknowingly pay more for a loan that did not require documentation.

The rule specifically authorizes a creditor to rely on W-2 forms, tax returns, payroll receipts, and financial institution records such as bank statements. These kinds of documents are sufficiently reliable sources of information about borrowers' income and assets that the Board believes it is appropriate to provide a safe harbor for their use. Moreover, most consumers can, or should be able to, produce one of these kinds of documents with little difficulty. For other consumers, the rule is quite flexible. It permits a creditor to rely on any third-party document that provides reasonably reliable evidence of the income or assets relied on to determine repayment ability. Examples include check-cashing or remittance receipts or a written statement from the consumer's employer. *See* comment 34(a)(4)(ii)(A)-3. These examples are only illustrative, not limiting. The one type of document that is excluded is a statement only from the consumer.

Many commenters suggested that the Board require creditors to collect the "best and most appropriate" documentation. The Board believes that the costs of such a requirement would outweigh the benefits. The vagueness of the suggested standard could make creditors reluctant to accept nontraditional forms of documentation. Nor is it clear how creditors would verify that a form of documentation that might be best or most appropriate was not available.

The commentary has been revised to clarify several points. *See* comments 34(A)(4)(ii)(A)-3 and -4. Oral information from a third party would not satisfy the rule, which requires documentation. Creditors may, however, rely on a letter or an e-mail from the third party. Creditors may also rely on third party documentation the consumer provides directly to the creditor. Furthermore, as interpreted by the comments, the rule excludes documents that are not specific to the consumer. It would not be sufficient to look at average incomes for the consumer's stated profession in the region where the consumer lives or average salaries for employees of the consumer's employer. The commentary has been revised, however, to indicate that creditors may use third party information that aggregates individual-specific data about consumers' income, such as a database service used by an employer to centralize income verification requests, so long as the information is reasonably current and accurate and identifies the specific consumer's income.

The rule does not require creditors that have extended credit to a consumer and wish to extend new credit to the same consumer to re-collect documents that the creditor previously collected from the consumer, if the creditor believes the documents would not have changed since they were initially verified. *See* comment 34(a)(4)(ii)(A)-5. For example, if the creditor has collected the consumer's 2006 tax return for a May 2007 loan, and the creditor makes another loan to that consumer in August 2007, the creditor may rely on the 2006 tax return.

Nor does the rule require a creditor to verify amounts of income or assets the creditor is not relying on to determine repayment ability. For example, if a creditor does not rely on a part of the consumer's income, such as an annual bonus, in determining repayment ability, the creditor would not need to verify the consumer's bonus. A creditor may verify an amount of income or assets less than that stated in the loan file if adequate to determine repayment ability. If a creditor does not verify sufficient amounts to support a determination that the consumer has the ability to pay the loan, however, then the creditor risks violating the regulation.

Self-employed borrowers. The Board has sought to address commenters' concerns about self-employed borrowers. The rule allows for flexibility in underwriting standards so that creditors may adapt their underwriting processes to the

needs of self-employed borrowers, so long as creditors comply with § 226.34(a)(4). For example, the rule does not dictate how many years of tax returns or other information a creditor must review to determine a self-employed applicant's repayment ability. Nor does the rule dictate which income figure on the tax returns the creditor must use. The Internal Revenue Code may require or permit deductions from gross income, such as a deduction for capital depreciation, that a creditor reasonably would regard as not relevant to repayment ability.

The rule is also flexible as to consumers who depend heavily on bonuses and commissions. If an employed applicant stated that he was likely to receive an annual bonus of a certain amount from the employer, the creditor could verify the statement with third-party documents showing a consumer's past annual bonuses. *See* comment 34(a)(4)(ii)-1. Similarly, employees who work on commission could be asked to produce third-party documents showing past commissions.

The Board is not adopting the exemption some commenters requested for self-employed borrowers. The exemption would give borrowers and originators an incentive to declare a borrower employed by a third party to [*44548] be self-employed to avoid having to verify the borrower's income. It is not clear how a declaration of self-employed status could be verified except by imposing the very burden the exemption would be meant to avoid, such as reviewing tax returns.

The affirmative defense. The Board received a number of comments about the proposed affirmative defense for a creditor that can show that the amounts of the consumer's income or assets the creditor relied on were not materially greater than what the creditor could have documented at consummation. The Board's reference to this defense as a "safe harbor" appears to have caused some confusion. Many commenters interpreted the phrase "safe harbor" to mean that the Board was proposing a specific way to comply with the rule. These commenters either criticized the safe harbor as insufficiently specific about how to comply (in the case of industry commenters) or urged that it be eliminated as a major loophole for avoiding verifying income and assets (in the case of consumer group and other commenters).

The Board intended the provision merely as a defense for a lender that did not verify income as required where the failure did not cause injury. The provision would place the burden on the lender to prove that its non-compliance was immaterial. A creditor that does not verify income has no assurance that the defense will be available should the loan be challenged in court. This creditor takes a substantial risk that it will not be able to prove through discovery that the income was as stated. Therefore, the Board expects that the defense will be used only in limited circumstances. For example, a creditor might be able to use the defense when a *bona fide* compliance error, such as an occasional failure of reasonable procedures for collecting and retaining appropriate documents, produces litigation. The defense is not likely to be helpful to a creditor in the case of compliance examinations because there will not be an opportunity in that context for the creditor to determine the borrower's actual income. With this clarification, the Board is adopting the affirmative defense as proposed.

The defense is available only where the creditor can show that the amounts of income and assets relied on were not materially greater than the amounts the creditor could have verified. The definition of "material" is not based on a numerical threshold as some commenters suggested. Rather, the commentary has been revised to clarify that creditors would be required to show that, if they had relied on the amount of verifiable income or assets, their decision to extend credit and the terms of the credit would not have been different. *See* comment 34(a)(4)(ii)(B)-2.

Narrower alternatives. The Board sought comment on whether the rule should be narrowed to prohibit only extending credit where the creditor or mortgage broker engaged in, influenced the borrower to engage in, or knew of income or asset inflation. The vast majority of commenters who addressed this alternative did not support it, and the Board is not adopting it. Placing the burden on the borrower or supervisory agency to prove the creditor knew the income was inflated would undermine the rule's effectiveness. In the case of borrower claims or counter-claims, this burden would lead to costly discovery into factual questions, and this discovery would often produce conflicting evidence ("he said, she said") that would require trial before a factfinder. A creditor significantly increases the risk of income inflation when it accepts a mere statement of income, and the creditor is in the best position to substantially reduce this risk at limited cost by simply requiring documentation. The Board believes this approach is the most effective and efficient way to protect not just the individual borrower but also the neighbors and communities that can suffer from spillover effects of unaffordable lending.

Some industry commenters suggested adopting an affirmative defense for creditors who can show that the consumer intentionally misrepresented income or assets or committed fraud. The Board is not adopting this defense. As discussed above, a rule that provided creditors with a defense where no documentation was present could result in litigation that was costly for both sides. A defense for cases of consumer misrepresentation or fraud where the creditor do-

cumented the consumer's income or assets would be unnecessary. Creditors are allowed to rely on documents provided directly by the consumer so long as those documents provide reasonably reliable evidence of the consumer's income or assets. A consumer who provided false documentation to the creditor, and who wished to bring a claim against the creditor, would have to demonstrate that the creditor reasonably should not have relied on the document. If the only fact that made the document unreliable was the consumer's having provided false information without the creditor's knowledge, it would not have been unreasonable for the creditor to rely on that document.

Obligations. The proposal essentially required a creditor to verify repayment ability; it provided that a pattern or practice of failing to verify repayment ability created a presumption of a violation. A proposed comment indicated that verifying repayment ability included verifying obligations. *See* proposed comment 34(a)(4)(i)(A)-2. The final rule explicitly includes the requirement to verify obligations in the regulation. *See* § 226.34(a)(4)(ii)(C). A comment to this provision indicates that a credit report may be used to verify current obligations. A credit report, however, might not reflect certain obligations undertaken just before or at consummation of the transaction and secured by the same dwelling that secures the transaction (for example, a "piggyback" second-lien transaction used to finance part of the down payment on the house where the first-lien transaction is for home purchase). A creditor is responsible for considering such obligations of which the creditor has knowledge. *See* comment 34(a)(4)-3.

Presumption of Compliance

The Board proposed to add new, rebuttable presumptions of violations to § 226.34(a)(4) and, by incorporation, § 226.35(b)(1). These presumptions would have been for engaging in a pattern or practice of failing to consider: consumers' ability to pay the loan based on the interest rate specified in the regulation; consumers' ability to make fully-amortizing loan payments that include expected property taxes and homeowners insurance; the ratio of borrowers' total debt obligations to income as of consummation; and borrowers' residual income. *See* proposed § 226.34(a)(4)(i)(B)-(E). The Board also proposed a presumption of compliance for a creditor that has a reasonable basis to believe that consumers will be able to make loan payments for at least seven years, considering each of the factors identified in § 226.34(a)(4)(i) and any other factors relevant to determining repayment ability.

The final rule removes the proposed presumptions of violation for failing to follow certain underwriting practices and incorporates these practices, with modifications, into a presumption of compliance that is substantially revised from that proposed. Under § 226.34(a)(4)(iii), a creditor is presumed to have complied with § 226.34(a)(4) if the creditor satisfies each of three requirements: (1) Verifying repayment ability; (2) determining the consumer's repayment ability using largest scheduled payment of principal and [*44549] interest in the first seven years following consummation and taking into account property tax and insurance obligations and similar mortgage-related expenses; and (3) assessing the consumer's repayment ability using at least one of the following measures: a ratio of total debt obligations to income, or the income the consumer will have after paying debt obligations. (The procedures for verifying repayment ability are required under paragraph 34(a)(4)(ii); the other procedures are not required.)

Unlike the proposed presumption of compliance, the presumption of compliance in the final rule is not conditioned on a requirement that a creditor have a reasonable basis to believe that a consumer will be able to make loan payments for a specified period of years. Comments from creditors indicated this proposed requirement was not necessary and introduced an undue degree of compliance uncertainty. The final presumption of compliance, therefore, replaces this general requirement with the three specific procedural requirements mentioned in the previous paragraph.

The creditor's presumption of compliance for following these procedures is not conclusive. The Board believes a conclusive presumption could seriously undermine consumer protection. A creditor could follow the procedures and still disregard repayment ability in a particular case or potentially in many cases. Therefore, the borrower may rebut the presumption with evidence that the creditor disregarded repayment ability despite following these procedures. For example, evidence of a very high debt-to-income ratio and a very limited residual income could be sufficient to rebut the presumption, depending on all of the facts and circumstances. If a creditor fails to follow one of the non-mandatory procedures set forth in paragraph 34(a)(4)(iii), then the creditor's compliance is determined based on all of the facts and circumstances without there being a presumption of either compliance or violation. *See* comment 34(a)(4)(iii)-1.

Largest scheduled payment in seven years. When a loan has a fixed rate and a fixed payment that fully amortizes the loan over its contractual term to maturity, there is no ambiguity about the rate and payment at which the lender should assess repayment ability: The lender will use the fixed rate and the fixed payment. But when the rate and payment can change, as has often been true of subprime loans, a lender has to choose a rate and payment at which to assess repayment ability. The Board proposed that a creditor would be presumed to have disregarded repayment ability if it

had engaged in a pattern or practice of failing to use the fully-indexed rate (or the maximum rate in seven years on a step-rate loan) and the fully-amortizing payment.

As discussed, the final rule does not contain this proposed presumption of violation. Instead, it provides that a creditor will have a presumption of compliance if, among other things, the creditor uses the largest scheduled payment of principal and interest in the first seven years. This payment could be higher, or lower, than the payment determined according to the fully-indexed rate and fully-amortizing payment. The Board believes that the final rule is clearer and simpler than the proposal. It incorporates long-established principles in Regulation Z for determining a payment schedule when rates or payments can change, which should facilitate compliance. *See* comment 34(a)(4)(iii)(B)-1. The final rule is also more flexible than the proposal. Instead of requiring the creditor to use a particular payment, it provides the creditor who uses the largest scheduled payment in seven years a presumption of compliance. The creditor has the flexibility to use a lower payment, and no presumption of violation would attach; though neither would a presumption of compliance. Instead, compliance would be determined based on all of the facts and circumstances.

Two aspects of § 226.34(a)(4) help ensure that this approach provides consumers effective protection. First, the Board is adopting the proposed seven-year horizon. That is, under § 226.34(a)(4)(iii)(B) the relevant payment for underwriting is the largest payment in seven years. Industry commenters requested that the rule incorporate a time horizon of no more than five years. As these commenters indicated, most subprime loans, including those with fixed rates, have paid off (or defaulted) within five years. It is possible that prepayment speeds will slow, however, as subprime lending practices and loan terms undergo substantial changes. Moreover, the final rule addresses commenters' concern that the proposal seemed to require them to project the consumer's income, employment, and other circumstances for as long as seven years as a condition to obtaining a presumption of compliance. Under the final rule, the creditor is expected to underwrite based on the facts and circumstances that exist as of consummation. Section 226.34(a)(4)(iii)(B) sets out the payment to which the creditor should underwrite if it seeks to have a presumption of compliance. Furthermore, nothing in the regulation prohibits, or creates a presumption against, loan products that are designed to serve consumers who legitimately expect to sell or refinance sooner than seven years.

A second aspect of § 226.34(a)(4) that is integral to its balance of consumer protection and credit availability is its exclusion of two nontraditional types of loans from the presumption of compliance that can pose more risk to consumers in the subprime market. Under § 226.34(a)(4)(iv), no presumption of compliance is available for a balloon-payment loan with a term shorter than seven years. If the term is at least seven years, the creditor that underwrites the loan based on the regular payments (not the balloon payment) may retain the presumption of compliance. If the term is less than seven years, compliance is determined on the basis of all of the facts and circumstances. This approach is simpler than some of the alternatives commenters recommended to address balloon-payment loans, and it better balances consumer protection and credit availability than other alternatives they suggested. n69 Consumers are statistically very likely to prepay (or default) within seven years and avoid the balloon payment.

n69 One large lender contended that balloon loans should be exempted from a repayment-ability rule because consumers understand their risks. Another recommended that balloon loans be exempted from the repayment ability rule if the term of the loan exceeds seven years for first-lien mortgages or five years for subordinate-lien loans. A trade association representing community banks urged that balloon payments be permitted so long as the creditor has a reasonable basis to believe the borrower will make the payments for the term of the loan except the final, balloon payment. This trade association indicated that community banks often structure the loans they hold in portfolio as 3- or 5-year balloon loans, typically with 15-30 year amortization periods, to match the maturity of the loan to the maturity of their deposit base. A lender and a lender trade association recommended using on short-term balloon loans a payment larger than the scheduled payment but smaller than the fully-amortizing payment, such as the payment that would correspond to an interest rate two percentage points higher than the rate specified in the presumption of compliance.

Loans with scheduled payments that would increase the principal balance (negative amortization) within the first seven years are also excluded from the presumption of compliance. This exclusion will help ensure that the presumption is available only for loans that leave the consumer sufficient equity after seven years to refinance. If the payments scheduled for the first seven years would cause the balance to increase, then compliance is determined [*44550] on all of the facts and circumstances without a presumption of compliance or violation.

"Interest-only" loans can have a presumption of compliance. With these loans, after an initial period of interest-only payments the payment is recast to fully amortize the loan over the remaining term to maturity. If the period of interest-only payments is shorter than seven years, the creditor may retain the presumption of compliance if it uses the fully-amortizing payment that commences after the interest-only period. If the interest-only period is seven years or longer,

the creditor may retain the presumption of compliance if it assesses repayment ability using the interest-only payment. Examples have been added to the commentary to facilitate compliance. *See* comment 34(a)(4)(iii)(B)-1. Examples of variable-rate loans and a step-rate loan have also been added.

Debt-to-income ratio and residual income. The proposal provided that a creditor would be presumed to have violated the regulation if it engaged in a pattern or practice of failing to consider the ratio of consumers' total debt obligations to consumers' income or the income consumers will have after paying debt obligations. A major secondary market participant proposed that considering total DTI and residual income not be an absolute prerequisite because other measures of income, assets, or debts may be valid methods to assess repayment ability. A credit union trade association contended that residual income is not a necessary underwriting factor if a lender uses DTI. Consumer and civil rights groups, however, specifically support including both DTI and residual income as factors, contending that residual income is an essential component of an affordability analysis for lower-income families.

Based on the comments and its own analysis, the Board is revising the proposal to provide that a creditor does not have a presumption of compliance with respect to a particular transaction unless it uses at least one of the following: the consumer's ratio of total debt obligations to income, or the income the consumer will have after paying debt obligations. Thus, the final rule permits a creditor to retain a presumption of compliance so long as it uses at least one of these two measures.

The Board believes the flexibility permitted by the final rule will help promote access to responsible credit without weakening consumer protection. The rule provides creditors flexibility to determine whether using both a DTI ratio and residual income increases a creditor's ability to predict repayment ability. If one of these metrics alone holds as much predictive power as the two together, as may be true of certain underwriting models at certain times, then conditioning access to a safe harbor on using both metrics could reduce access to credit without an offsetting increase in consumer protection. The Board also took into account that, at this time, residual income appears not to be as widely used or tested as the DTI ratio. n70 It is appropriate to permit the market to develop more experience with residual income before considering whether to incorporate it as an independent requirement of a regulatory presumption of compliance.

n70 Michael E. Stone, *What is Housing Affordability? The Case for the Residual Income Approach,* 17 Housing Policy Debate 179 (Fannie Mae 2006) (advocating use of a residual income approach but acknowledging that it "is neither well known, particularly in this country, nor widely understood, let alone accepted").

The final rule does not contain quantitative thresholds for either of the two metrics. The Board specifically solicited comment on whether it should adopt such thresholds. Industry commenters did not favor providing a presumption of compliance (or a presumption of a violation) based on a specified debt-to-income ratio. The reasons given include: Different investors have different guidelines for lenders to follow in calculating DTI; underwriters following the same procedures can calculate different DTIs on the same loan; borrowers may want or, in some high-cost areas, may need to spend more than any specified percentage of their income on housing and may have sufficient non-collateral assets or residual incomes to support the loan; and loans with high DTIs have not necessarily had high delinquency rates. Two trade associations indicated they would accept a quantitative safe harbor if it were sufficiently flexible. Some commenters suggested a standard of reasonableness.

Consumer and civil rights groups, a federal banking agency, and others requested that the Board set threshold levels for both DTI and residual income beyond which a loan would be considered unaffordable, subject to rebuttal by the creditor. They argued that quantitative thresholds for these factors would improve compliance and loan performance. These commenters suggested that the regulation should expressly recognize that, as residual income increases, borrowers can support higher DTI levels. They provided alternative recommendations: mandate the DTI and residual income levels found in the guidelines for loans guaranteed by the Department of Veterans Affairs, 38 CFR 36.4840; develop the Board's own guidelines; or impose a threshold of 50 percent DTI with sufficient residual income. A consumer research and advocacy group, however, supported the Board's proposal not to set a quantitative threshold. It specifically opposed a 50 percent threshold as too high for sustainable lending. It further maintained that any specific DTI threshold would not be workable because proper underwriting depends on too many factors, and the definition of "debt" is too easily manipulated.

The Board is concerned that making a specific DTI ratio or residual income level either a presumptive violation or a safe harbor could limit credit availability without providing adequate offsetting benefits. The same debt-to-income ratio can have very different implications for two consumers' repayment ability if the income levels of the consumers differ significantly. Moreover, it is not clear what thresholds would be appropriate. Limited data are available to the Board to support such a determination. Underwriting guidelines of the Department of Veterans Affairs may be appro-

priate for the limited segment of the mortgage market this agency is authorized to serve, but they are not necessarily appropriate for the large segment of the mortgage market this regulation will cover.

Safe Harbors and Exemptions Not Adopted

Commenters requested several safe harbors or exemptions that the Board is not adopting. Many industry commenters sought a safe harbor for any loan approved by the automated underwriting system (AUS) of Fannie Mae or Freddie Mac; some sought a safe harbor for an AUS of any federally-regulated institution. The Board is not adopting such a safe harbor. Commenters did not suggest a clear and objective definition of an AUS that would distinguish it from other types of systems used in underwriting. It would not be appropriate to try to resolve this concern by limiting a safe harbor to the AUS's of Fannie Mae and Freddie Mac, as that would give them an unfair advantage in the marketplace. Moreover, a safe harbor for an AUS that is a "black box" and is not specifically required to comply with the regulation could undermine the regulation. Some industry commenters sought safe harbors for transactions that provide the consumer a lower rate or payment on the grounds that these transactions would generally benefit the borrower. [*44551] The chief example given is a refinance (without cash out) that reduces the consumer's current monthly payment or, in the case of an ARM, the payment expected upon reset. The Board does not believe that a safe harbor for such a transaction would benefit consumers. For example, it could provide an incentive to an originator to make an unaffordable loan to a consumer and then repeatedly refinance the loan with new loans offering a slightly lower payment each time.

One state Attorney General submitted a comment supporting permitting an asset-based loan where the borrower has suffered a loss of income but reasonably anticipates improving her circumstances (*e.g.*, temporary disability or illness, unemployment, or salary cut), or the borrower seeks a short-term loan because she must sell the home due to a permanent reduction in income (*e.g.*, loss of job, or divorce from co-borrower) or some other event (*e.g.*, pending foreclosure or occurrence of natural disaster). An association of mortgage brokers also recommended that exceptions be made for such cases.

The Board is not adopting safe harbors or exemptions for such "hardship" cases. As discussed above, the Board recognizes that consumers in such situations who fully understood the risks involved would benefit from having the ability to address their situation by taking a large risk with their home equity. At the same time, the Board is concerned that exceptions for such cases could severely undermine the rule because it would be difficult, if not impossible, to distinguish *bona fide* cases from mere circumvention. For some of these cases, such as selling a home due to divorce or job loss (or any reason) and purchasing a new, presumably less expensive home, the carve-out for bridge loans may apply.

C. Prepayment Penalties-- § 226.32(d)(6) and (7); § 226.35(b)(2)

The Board proposed to apply to higher-priced mortgage loans the prepayment penalty restrictions that TILA Section 129(c) applies to HOEPA loans. Specifically, HOEPA-covered loans may only have a prepayment penalty if: The penalty period does not exceed five years from loan consummation; the penalty does not apply if there is a refinancing by the same creditor or its affiliate; the borrower's debt-to-income (DTI) ratio at consummation does not exceed 50 percent; and the penalty is not prohibited under other applicable law. 15 U.S.C. 1639(c); see also 12 CFR 226.32(d)(6) and (7). In addition, the Board proposed, for both HOEPA loans and higher-priced mortgage loans, to require that the penalty period expire at least sixty days before the first date, if any, on which the periodic payment amount may increase under the terms of the loan.

Based on the comments and its own analysis, the Board is adopting substantially revised rules for prepayment penalties. There are two components to the final rule. First, the final rule prohibits a prepayment penalty with a higher-priced mortgage loan or HOEPA loan if payments can change during the four-year period following consummation. Second, for all other higher-priced mortgage loans and HOEPA loans--loans whose payments may not change for four years after consummation--the final rule limits prepayment penalty periods to a maximum of two years following consummation, rather than five years as proposed. In addition, the final rule applies to this second category of loans two requirements for HOEPA loans that the Board proposed to apply to higher-priced mortgage loans: the penalty must be permitted by other applicable law, and it must not apply in the case of a refinancing by the same creditor or its affiliate.

The Board is not adopting the proposed rule requiring a prepayment penalty provision to expire at least sixty days before the first date on which a periodic payment amount may increase under the loan's terms. The final rule makes such a rule unnecessary. Under the final rule, if the consumer's payment may change during the first four years following consummation, a prepayment penalty is prohibited outright. If the payment is fixed for four years, the final rule lim-

its a prepayment penalty period to two years, leaving the consumer a penalty-free window of at least two years before the payment may increase.

In addition, for the reasons discussed below, the Board is not adopting the proposed rule prohibiting a prepayment penalty where a consumer's verified DTI ratio, as of consummation, exceeds 50 percent. This restriction, however, will continue to apply to HOEPA loans, as provided by the statute.

Under Regulation Z, 12 CFR 226.23(a)(3), footnote 48, a HOEPA loan having a prepayment penalty that does not conform to the requirements of § 226.32(d)(7) is a mortgage containing a provision prohibited by TILA Section 129, 15 U.S.C. 1639, and therefore is subject to the three-year right of the consumer to rescind. Final § 226.35(b)(2), which the Board is adopting under the authority of Section 129(l)(2), 15 U.S.C. 1639(l)(2), applies restrictions on prepayment penalties for higher-priced mortgage loans that are substantially the same as the restrictions that § 226.32(d)(6) and (7) apply on prepayment penalties for HOEPA loans. Accordingly, the Board is revising footnote 48 to clarify that a higher-priced mortgage loan (whether or not it is a HOEPA loan) having a prepayment penalty that does not conform to the requirements of § 226.35(b)(2) also is subject to a three-year right of rescission. (The right of rescission, however, does not extend to home purchase loans, construction loans, or certain refinancings with the same creditor.)

Public Comment

The Board received public input about the advantages and disadvantages of prohibiting or restricting prepayment penalties in testimony provided at the 2006 and 2007 hearings the Board conducted on mortgage lending, and in comment letters associated with these hearings. In the official notice of the 2007 hearing, the Board expressly asked for oral and written comment about the effects of a prohibition or restriction under HOEPA on prepayment penalties on consumers and on the type and terms of credit offered. 72 FR 30380, 30382 (May 31, 2007). Most consumer and community groups, as well as some state and local government officials and a trade association for community development financial institutions, urged the Board to prohibit prepayment penalties with subprime loans. By contrast, most industry commenters opposed prohibiting prepayment penalties or restricting them beyond requiring that they expire sixty days before reset, on the grounds that a prohibition or additional restrictions would reduce credit availability in the subprime market. Some industry commenters, however, stated that a three-year maximum prepayment penalty period would be appropriate.

In connection with the proposed rule, the Board asked for comment about the benefits and costs of prepayment penalties to consumers who have higher-priced mortgage loans, as well as about the costs and benefits of the specific restrictions proposed. Most financial institutions and their trade associations stated that consumers should be able to choose a loan with a prepayment penalty in order to lower their interest rate. Many of these commenters stated that prepayment penalties help creditors to manage prepayment risk, which in turn increases credit availability and lowers credit costs. Industry commenters generally opposed the proposed rule that would prohibit prepayment [*44552] penalties in cases where a consumer's DTI ratio exceeds 50 percent. The few industry commenters that addressed the proposal to require that a prepayment penalty not apply in the case of a refinancing by the creditor or its affiliate opposed the provision. These commenters supported, or did not oppose, the proposal to require prepayment penalties to expire at least sixty days before any possible payment increase. Several financial institutions, an industry trade association, and a secondary-market investor recommended that the Board set a three-year maximum penalty period instead of a five-year maximum.

By contrast, many other commenters, including most consumer organizations, several trade associations for state banking authorities, a few local, state, and federal government officials, a credit union trade association, and a real estate agent trade association, supported prohibiting prepayment penalties for higher-priced mortgage loans and HOEPA loans. Many of these commenters stated that the cost of prepayment penalties to subprime borrowers outweigh the benefits of any reductions in interest rates or up-front fees they may receive. These commenters stated that the Board's proposed rule would not address adequately the harms that prepayment penalties cause consumers. Several commenters recommended alternative restrictions of prepayment penalties with higher-priced mortgage loans and HOEPA loans if the Board did not prohibit such penalties, including limiting a prepayment penalty period to two or three years following consummation or prohibiting prepayment penalties with ARMs.

Public comments are discussed in greater detail throughout this section.

Discussion

For the reasons discussed below, the Board concludes that the fairness of prepayment penalty provisions on higher-priced mortgage loans and HOEPA loans depends to an important extent on the structure of the mortgage loan. It has been common in the subprime market to structure loans to have a short expected life span. This has been achieved by building in a significant payment increase just a few years after consummation. With respect to subprime loans designed to have shorter life spans, the injuries from prepayment provisions are potentially the most serious, as well as the most difficult for a reasonable consumer to avoid. For these loans, therefore, the Board concludes that the injuries caused by prepayment penalty provisions with subprime loans outweigh their benefits. With respect to subprime loans structured to have longer expected life spans, however, the Board concludes that the injuries from prepayment penalties are closer to being in balance with their benefits, warranting restrictions but not, at this time, a prohibition.

Background. Prepayment risk is the risk that a loan will be repaid before the end of the loan term, a major risk of mortgage lending. Along with default risk, it is the major risk of extending mortgage loans. When mortgages prepay, cash flow from loan payments may not offset origination expenses or discounts consumers were provided on fees or interest rates. Moreover, prepayment when market interest rates are declining, which is when borrowers are more likely to prepay, forces investors to reinvest prepaid funds at a lower rate. Furthermore, prepayment by subprime borrowers whose credit risk declines (for example, their equity or their credit score increases) leaves an investor holding relatively riskier loans.

Creditors seek to account for prepayment risk when they set loan interest rates and fees, and they may also seek to address prepayment risk with a prepayment penalty. A prepayment penalty is a fee that a borrower pays if he repays a mortgage within a specified period after origination. A prepayment penalty can amount to several thousand dollars. For example, a consumer who obtains a 3-27 ARM with a thirty-year term for a loan in the amount of $ 200,000 with an initial rate of 6 percent would have a principal balance of $ 194,936 at the end of the second year following consummation. If the consumer pays off the loan, a penalty of six months' interest on the remaining balance--close to six monthly payments--will cost the consumer about $ 5,850. n71 A penalty of this magnitude reduces a borrower's likelihood of prepaying and assures a return for the investor if the borrower does prepay.

n71 This is a typical contractual formula for calculating the penalty. There are other formulas for calculating the penalty, such as a percentage of the amount prepaid or of the outstanding loan balance (potentially reduced by the percentage (for example, 20 percent) that a borrower, by law or contract, may prepay without penalty). As explained further below, a consumer may pay a lower rate in exchange for having a provision providing for a penalty of this magnitude.

Substantial injury. Prepayment penalty provisions have been very common on subprime loans. Almost three-quarters of loans in a large dataset of securitized subprime loan pools originated from 2003 through the first half of 2007 had a prepayment penalty provision. n72 These provisions cause many consumers who pay the penalty, as well as many consumers who cannot, substantial injuries. The risk of injury is particularly high for borrowers who receive loans structured to have short expected life spans because of a significant expected payment increase.

n72 Figure calculated from First American LoanPerformance data.

A borrower with a prepayment penalty provision who has reason to refinance while the provision is in effect must choose between paying the penalty or foregoing the refinance, either of which could be very costly. Paying the penalty could exact several thousand dollars from the consumer; financing the penalty through the refinance loan adds interest to that cost. When the consumer's credit score has improved, delaying the refinance until the penalty expires could mean losing or at least postponing an opportunity to lower the consumer's interest rate. Declining to pay the penalty also could mean foregoing or delaying a "cash out" loan that would consolidate several large unsecured debts at a lower rate or help the consumer meet a major life expense, such as for medical care. Borrowers who have no ability to pay or finance the penalty, however, have no choice but to forego or delay any benefits from refinancing.

Prepayment penalty provisions also exacerbate injuries from unaffordable or abusive loans. In the worst case, where a consumer has been placed in a loan he cannot afford to pay, delaying a refinancing could increase the consumer's odds of defaulting and, ultimately, losing the house. n73 Borrowers who were steered to loans with less favorable terms than they qualify for based on their credit risk face an "exit tax" for refinancing to improve their terms.

n73 For the reasons set forth in part II.B., consumers in the subprime market have had a high risk of receiving loans they cannot afford to pay. The Board expects that the rule prohibiting disregard for repayment ability will reduce this risk substantially, but no rule can eliminate it. Moreover, its success depends on vigorous enforcement by a wide range of agencies and jurisdictions.

Prepayment penalty provisions can cause more injury with loans designed to have short expected life spans. With these loans, borrowers are particularly likely to want to prepay in a short time to avoid the expected payment increase. Moreover, in recent years, loans designed to have short expected life spans have been among the most difficult for borrowers to afford--even before their payment increases. Borrowers with 2-28 and 3-27 ARMs have been much more likely to become [*44553] seriously delinquent than borrowers with fixed-rate subprime mortgages. In part, the difference reflects that borrowers receiving 2-28 and 3-27 ARMs have had lower average credit scores and less equity in their homes at origination. But the large difference also suggests that these shorter-term loans were more likely to be marketed and underwritten in ways that increase the risk of unaffordability. A prepayment penalty provision exacerbates this injury, especially because borrowers with lower credit scores are the most likely to have a need to refinance to extract cash.

Injury not reasonably avoidable. In the prime market, the injuries prepayment penalties cause are readily avoidable because lenders do not typically offer borrowers mortgages with prepayment penalty provisions. Indeed, in one large dataset of first-lien prime loans originated from 2003 to mid-2007 just six percent of loans had these provisions. n74 In a dataset of subprime securitized loans originated during the same period, however, close to three-quarters had a prepayment penalty provision. n75 Moreover, evidence suggests that a large proportion of subprime borrowers with prepayment penalty provisions have paid the penalty. Approximately 55 percent of subprime 2-28 ARMs in this same dataset originated from 2000 to 2005 prepaid while the prepayment penalty provision was in effect. n76 The data do not indicate how many consumers actually paid a penalty, or how much they paid. But the data suggest that a significant percentage of borrowers with subprime loans have paid prepayment penalties, which, as indicated above, can amount to several thousand dollars.

n74 Figure calculated from McDash Analytics data.

n75 Figure calculated from First American LoanPerformance data.

n76 *Id.*

These figures raise a serious question as to whether a substantial majority of subprime borrowers have knowingly and voluntarily taken the very high risk of paying a significant penalty. While subprime borrowers receive some rate reduction for a prepayment penalty provision (as discussed at more length in the next subsection), they also have major incentives to refinance. They often have had difficulty meeting their regular obligations and experienced major life disruptions. Many would therefore anticipate refinancing to extract equity to consolidate their debts or pay a major expense; nearly 90 percent of subprime ARMs used for refinancings in recent years were "cash out." n77 In addition, many subprime borrowers would aspire to refinance for a lower rate when their credit risk declines (for example, their credit score improves, or their equity increases).

n77 *Id.* It is not possible to discern from the data whether the cash was used only to cover the costs of refinancing or also for other purposes. *See also Subprime Refinancing* at 233 (reporting that 49 percent of subprime refinance loans involve equity extraction, compared with 26 percent of prime refinance loans); *Subprime Outcomes* at 368-371 (discussing survey evidence that borrowers with subprime loans are more likely to have experienced major adverse life events (marital disruption; major medical problem; major spell of unemployment; major decrease of income) and often use refinancing for debt consolidation or home equity extraction); *Subprime Lending Investigation* at 551-52 (citing survey evidence that borrowers with subprime loans have increased incidence of major medical expenses, major unemployment spells, and major drops in income).

Prepayment penalties' lack of transparency also suggests that prepayment penalty provisions are often not knowingly and voluntarily chosen by subprime borrowers whose loans have them. In the subprime market, information on rates and fees is not easy to obtain. *See* part II.B. Information on prepayment penalties, such as how large they can be or how many consumers actually pay them, is even harder to obtain. The lack of transparency is exacerbated by originators' incentives--largely hidden from consumers--to "push" loans with prepayment penalty provisions and at the same time obscure or downplay these provisions. If the consumer seeks the lowest monthly payment--as the consumer in the subprime market often does--then the originator has a limited incentive to quote the payment for a loan without a prepayment penalty provision, which will tend to be at least slightly higher. Perhaps more importantly, lenders pay originators considerably larger commissions for loans with prepayment penalties, because the penalty assures the lender a larger revenue stream to cover the commission. The originator also has an incentive not to draw the consumer's attention to the prepayment penalty provision, in case the consumer should prefer a loan without it. Although the prepayment penalty provision must be disclosed on the post-application TILA disclosure, the consumer may not notice it amidst

numerous other disclosures or may not appreciate its significance. Moreover, an unscrupulous originator may not disclose the penalty until closing, when the consumer's ability to negotiate terms is much reduced.

Even a consumer offered a genuine choice would have difficulty comparing the costs of subprime loans with and without a penalty, and would likely choose to place more weight on the more certain and tangible cost of the initial monthly payment. There is a limit to the number of factors a consumer can reasonably be expected to consider, so the more complex a loan the less likely the consumer is to consider the prepayment penalty. For example, an FTC staff study found that consumers presented with mortgage loans with more complex terms were more likely to miss or misunderstand key terms. n78

n78 *Improving Consumer Mortgage Disclosures* at 74 ("[R]espondents had more difficulty recognizing and identifying mortgage cost in the complex-loan scenario. This implies that borrowers in the subprime market may have more difficulty understanding their loan terms than borrowers in the prime market. The difference in understanding, however, would be due largely to differences in the complexities of the loans, rather than the capabilities of the borrowers.").

These concerns are magnified with subprime loans structured to have short expected life spans, which will have variable rates (such as 2-28 and 3-27 ARMs) or other terms that can increase the payment. Adjustable-rate mortgages are complicated for consumers even without prepayment penalties. A Federal Reserve staff study suggests that borrowers with ARMs underestimate the amount by which their interest rates can change. n79 The study also suggests that the borrowers most likely to make this mistake have a statistically higher likelihood of receiving subprime mortgages (for example, they have lower incomes and less education). n80 Adding a prepayment penalty provision to an already-complex ARM product makes it less likely the consumer will notice, understand, and consider this provision when making decisions. Moreover, the shorter the period until the likely payment increase, the more the consumer will have to focus attention on the adjustable-rate feature of the loan and the less the consumer may be able to focus on other features.

n79 Brian Bucks and Karen Pence, *Do Borrowers Understand their Mortgage Terms?*, Journal of Urban Economics (forthcoming 2008).

n80 *Id.*

Moreover, subprime mortgage loans designed to have short expected life spans appear more likely than other types of subprime mortgages to create incentives for abusive practices. Because these loans create a strong incentive to refinance in a short time, they are likely to be favored by originators who seek to "flip" their clients through repeated refinancings to increase fee revenue; prepayment penalties are frequently associated with such a strategy. n81 Moreover, 2-28 and [*44554] 3-27 ARMs were marketed to borrowers with low credit scores as "credit repair" products, obscuring the fact that a prepayment penalty provision would inhibit or prevent the consumer who improved his credit score from refinancing at a lower rate. These loans were also associated more than other loan types with irresponsible underwriting and marketing practices that contributed to high rates of delinquency even before the consumer's payment increased.

n81 *See generally* U.S. Dep't of Hous. & Urban Dev. & U.S. Dep't of Treasury, *Recommendations to Curb Predatory Home Mortgage Lending* 73 (2000) ("Loan flipping generally refers to repeated refinancing of a mortgage loan within a short period of time with little or no benefit to the borrower."), available at *http://www.huduser.org/publications/pdf/treasrpt.pdf.*

Subprime loans designed to have short expected life spans also attracted consumers who are more vulnerable to abusive prepayment penalties. Borrowers with 2-28 and 3-27 ARMs had lower credit scores than borrowers with any other type of subprime loan. n82 These borrowers include consumers with the least financial sophistication and the fewest financial options. Such consumers are less likely to scrutinize a loan for a restriction on prepayment or negotiate the restriction with an originator, who in any event has an incentive to downplay its significance.

n82 Figures calculated from First American LoanPerformance data about securitized subprime pools show that the median FICO score was 627 for fixed-rate loans and 612 for short-term hybrid ARMs (2-28 and 3-27 ARMS).

Injury not outweighed by countervailing benefits to consumers or to competition. The Board concludes that prepayment penalties' injuries outweigh their benefits in the case of higher-priced mortgage loans and HOEPA loans designed with planned or potential payment increases after just a few years. For other types of higher-priced and HOEPA loans, however, the Board concludes that the injuries and benefits are much closer to being in equipoise. Thus, as ex-

plained further in the next section, the final rule prohibits penalties in the first case and limits them to two years in the second.

Prepayment penalties can increase market liquidity by permitting creditors and investors to price directly and efficiently for prepayment risk. This liquidity benefit is more significant in the subprime market than in the prime market. Prepayment in the subprime market is motivated by a wider variety of reasons than in the prime market, as discussed above, and therefore is subject to more uncertainty. In principle, prepayment penalty provisions allow creditors to charge most of the prepayment risk only to the consumers who actually prepay, rather than charging all of the risk in the form of higher interest rates or up-front fees for all consumers. The extent to which creditors have actually passed on lower rates and fees to consumers with prepayment penalty provisions in their loans is debated and, moreover, inherently difficult to measure. With limited exceptions, however, available studies, discussed at more length below, have shown consistently that loans with prepayment penalties carry lower rates or APRs than loans without prepayment penalties having similar credit risk characteristics. n83

n83 *See* Chris Mayer, Tomasz Piskorski, and Alexei Tchistyi, *The Inefficiency of Refinancing: Why Prepayment Penalties Are Good for Risky Borrowers* (Apr. 28, 2008) (*Why Prepayment Penalties Are Good*), *http://www1.gsb.columbia.edu/mygsb/faculty/research/pubfiles/3065/Inefficiency%20of%20Refinancing%2Epdf;* Gregory Elliehausen, Michael E. Staten, and Jevgenijs Steinbuks, *The Effect of Prepayment Penalties on the Pricing of Subprime Mortgages,* 60 Journal of Economics and Business 33 (2008) (*Effect of Prepayment Penalties*); Michael LaCour-Little, *Prepayment Penalties in Residential Mortgage Contracts: A Cost-Benefit Analysis* (Jan. 2007) (unpublished) (*Cost-Benefit Analysis*); Richard F. DeMong and James E. Burroughs, *Prepayment Fees Lead to Lower Interest Rates,* Equity (Nov./Dec. 2005), available at *http://www.commerce.virginia.edu/faculty_research/faculty_homepages/DeMong/PrepaymentsandInterestRates.pdf* (*Prepayment Fees Lower Rates*); *but see* Keith E. Ernst, Center for Responsible *Lending, Borrowers Gain No Interest Rate Benefit from Prepayment Penalties on Subprime Mortgages* (2005), *http://www.responsiblelending.org/pdfs/rr005-PPP_Interest_Rate-0105.pdf* (*No Interest Rate Benefit*).

Evidence of lower rates or APRs is not sufficient to demonstrate that penalties provide a net benefit to consumers. Some consumers may not have chosen the lower rates or APRs voluntarily and may have preferred *ex ante*, had they been properly informed, to have no prepayment penalty provision and somewhat higher rates or fees. Borrowers with these provisions who hold their loans past the penalty period are likely better off because they have lower rates and do not incur a prepayment penalty; but the benefit these borrowers receive may be small compared to the injury suffered by the many borrowers who pay the penalty, or who cannot pay it and are locked into an inappropriate or unaffordable loan. It does appear, however, that prepayment penalty provisions provide some benefit to at least some consumers in the form of reduced rates and increased credit availability.

In the case of higher-priced mortgage loans and HOEPA loans designed to have short expected life spans, the Board concludes that these potential benefits do not outweigh the injuries to consumers. Available studies generally have found reductions in interest rate or APR associated with subprime 2-28 ARMs and 3-27 ARMs to be minimal, ranging from 18 to a maximum of 29 basis points, with one study finding no rate reduction on such loans originated by brokers. n84 The one available (but unpublished) study to compare the rate reduction to the cost of the penalty itself found a net cost to the consumer with 2-28 and 3-27 ARMs. n85 The minimal rate reductions strengthen doubt that the high incidence of penalty provisions was the product of informed consumer choice. Moreover, for the reasons discussed above, prepayment penalties are likely to cause the most significant, and least avoidable, injuries when coupled with loans designed to have short expected life spans, which have proved to be the riskiest loans for consumers. On balance, therefore, the Board believes these injuries outweigh potential benefits.

n84 *See Effect of Prepayment Penalties* 43 (finding that the presence of a prepayment penalty reduced risk premiums by 18 basis points for hybrid loans and 13 basis points for variable-rate loans); *Prepayment Fees Lower Rates* 5 (stating that, for first-lien subprime loans with a thirty-year term, the presence of a prepayment penalty reduced the APR by 29 basis points for adjustable-rate loans and 20 basis points for interest-only loans).

n85 *Cost-Benefit Analysis* 26 ("For the [2-28] ARM product, the total interest rate savings is significantly less than the amount of the expected prepayment penalty; for the [3-28] ARM product, the two values are approximately equal.").

For higher-priced mortgage loans and HOEPA loans structured to have longer expected life spans, however, the Board concludes that the injuries and benefits are closer to being in balance. Studies that analyze both fixed-rate mortgages and 2-28 and 3-27 ARMs show a more significant reduction of rates and fees for fixed-rate mortgages for loans with prepayment penalties, ranging from 38 basis points n86 to 60 basis points. n87 Moreover, longer-term ARMs and